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Bank of Japan

Revisiting the Philosophy behind Central Bank Policy

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Masaaki Shirakawa

Governor of the Bank of Japan

Introduction

Thank you for your kind introduction. It is a great pleasure and an honor to have the opportunity to speak today at the Economic Club of New York, with its over one hundred years of history at the heart of the world's financial markets. 1907, the year this esteemed Club was founded, is also remembered as the year when the United States was struck by a nationwide banking crisis. There had been a few unsuccessful attempts to set up a central bank before the crisis, but in the aftermath of the Panic of 1907, the momentum to establish one strengthened, and the Federal Reserve System was created in 1913. Interestingly enough, the Bank of Japan, the Federal Reserve and the Economic Club of New York have had ties since the early days. Mr. Benjamin Strong, the first President, or at that time the Governor, of the Federal Reserve Bank of New York spent three months in Japan in 1920, developing a strong personal bond with the then Governor of the Bank of Japan, Junnosuke Inoue¹. On his return to the United States, Governor Strong donated many volumes of books to the Bank of Japan on the US financial system and the Federal Reserve. One of those books was, "A History of Currency in the Unites States", written by the first Chairman of this Club, Mr. Barton Hepburn². The book can still be found in our Bank's library, and by observing the red underlines on the pages of the book, I can comprehend that my predecessors had thoroughly read this book to study how the US had dealt with the financial crisis.

Speaking of financial crises, Japan experienced a severe financial crisis in the 1920s, and this led to the introduction of on-site examinations of financial institutions by the Bank of Japan, which continues to be a valuable source of information for the central bank today. For several decades after this crisis, the Japanese financial system did not face serious strains to its stability. However, from the mid-1990s to the early part of the 2000s, we were once again hit by a major financial crisis. In the case of the US, the current financial crisis which started in August 2007 is the worst crisis since the Great Depression-era. I assume many of you who are sitting here today had known of past financial crises, but did not expect to actually experience a crisis of this scope and magnitude during your life times. When we were experiencing our own bubble more than twenty years ago, I myself certainly

¹ See Governor Strong's remarks at the Tokyo Ginko Club (The Tokyo Bankers Club) during his stay in Japan (Strong [1920]).

² Hepburn [1915].

did not anticipate the severity of the crisis which we were to experience. Japan experienced its crisis more than ten years ago, but watching the US-triggered financial crisis unfold and spread across the global financial system, I cannot but help feel a sense of déjà vu. There are a number of similarities between these two episodes, for example, optimism immediately after the bursting of the bubble, delay in implementing some key policy measures, a prolonged economic downturn, hostility towards financial institutions, criticism aimed at supervisors, regulators and central bankers, to name some.

The current crisis has not reached the end of its cycle yet. However, as far as I can see at the moment, two pressing issues have emerged. First, we must bring the global economy back to a sustainable growth path. Second, we must prepare measures to prevent the recurrence of such a crisis. The Bank of Japan is making our utmost efforts to tackle these two challenges, working in cooperation with the Federal Reserve and other authorities. If we were to find a silver lining in the financial crisis, it would be that it has given all of us, including financial institutions, non-financial corporations and policymakers, the opportunity to rethink the validity of the mindset upon which business strategies are developed, and of the philosophy behind the policy conduct that we had become so accustomed to. In what follows, I would like to elaborate on these issues.

Why do financial crises repeatedly occur?

Why do financial crises, and for that matter bubbles which precede them, occur repeatedly? Many reasons are given -- lax risk management, excessive leverage, existence of financial institutions which are perceived to be too-big-to-fail, failure of supervision, excessively accommodative monetary policy and the list goes on. I generally agree with such assessments, but we also need a holistic perspective which cannot be captured just by focusing on individual causes. From this perspective, I would like to emphasize that, what one could term as a “cycle of confidence” which evolves over a very long time horizon, plays a decisive role. Success breeds confidence which unfortunately turns into over-confidence or even arrogance. Complacency also sets in. The collapse of the bubble based upon this over-confidence leads now to under-confidence, which is followed by rebuilding efforts. Then the cycle begins once again.

During the latter half of the 1980s, Japan’s economic performance stood out among the

advanced economies. While growth in the other G7 countries averaged 3.4%, the Japanese economy grew at an annual rate of 5.1%. The inflation rate measured by CPI was on average 3.9% in the G7 countries excluding Japan, while it was 1.1% in Japan. Although inflation targeting became popular later in the 1990s, if one were to apply the criteria used by countries adopting inflation targeting, Japan would have received an “A+” during the latter half of the 1980s. Externally, through a continuously large current account surplus, Japan became the world’s largest net creditor nation. In this benign environment, the Japanese became over-confident. Of course, there were worrying signs. The extension of credit increased sharply and asset prices boomed in the latter half of the 1980s. However, an “irrational bull sentiment” engulfed society, drowning out such concerns. With regard to land prices, the belief that land prices would never fall overwhelmed people’s mind. Naturally, the need for monetary policy to switch to a tightening mode was discussed. In fact, excluding one source of information, all of the economic data such as high growth, tight labor markets, surge in bank lending, and bloated asset prices were pointing to the need for withdrawing accommodative monetary policy. The only exception was the rate of inflation. Stable prices were a strong rebuttal against the Bank of Japan, which was trying to take away monetary ease. Entering into the 1990s, the landscape changed dramatically with the bursting of the bubble, and the Japanese economy came up against huge difficulties. The average growth rate fell from 5.1% in the latter half of the 1980s to 1.5% in the 1990s. As a result, extreme pessimism containing irrational elements, or what one can call “irrational bear sentiment”, emerged. There are multiple reasons for the sluggish performance of the Japanese economy in recent years and it would be inappropriate to over-emphasize the impact of the bursting of the bubble or asset deflation. However, there is no doubt that the bubble and its ensuing collapse had major implications for the long-term health of the Japanese economy.

This “cycle of confidence” seems to apply not only to the Japanese economy, but also to the US economy. Since the mid-1960s, the performance of the US economy started to deteriorate, and the late-70s and early-80s were the worst period, facing both high inflation and low growth, or in another word, stagflation. However, policy efforts to revitalize the US economy began precisely during this testing time. Chairman Volcker’s efforts to tame inflation and deregulation under the Reagan administration, both were set in motion during this difficult period, and the efforts gradually began to bear fruit over a long period of time.

The rate of growth of the US economy accelerated from 3.1% in the 1980s to 4.0% in the latter half of the 1990s. This economic expansion briefly paused at the beginning of the new century due to the collapse of the IT bubble, but accelerated once again after a relatively short period. There was much discussion regarding the macro economy and how to interpret the decrease in the volatility of the growth rate and inflation rate. The phrase “Great Moderation” was repeatedly mentioned. In this environment, a very bullish view regarding the economic outlook prevailed. There was much debate about whether the rise in house prices was a bubble or not. However, the basic messages we repeatedly heard from both policymakers and academia here in the United States were, that “there will not be a nationwide decline in house prices” and that “even if a bubble were to burst, it would be manageable through aggressive monetary easing”. With regard to the financial system, the presumption was that the risk management of US and European banks were much more sophisticated and efficient than that of Japanese banks³. Unfortunately, as we all know now, such optimistic views proved to be wrong. Both the Japanese case and US case show how damaging over-confidence can be.

Why couldn't policy makers put on the brakes?

I have taken you through a quick assessment of the recent bubbles in Japan and the United States from the perspective of a “cycle of confidence”. But looking around the globe, such episodes are not confined to these two cases. Just looking back at the last quarter of a century, there was the bubble and its collapse in the Nordic countries during the 1980s, and the Asian Miracle followed by the Asian currency crisis in the 1990s, to name a few. Human beings know that sometimes we become over-confident and our actions become excessive. That is why we have developed pre-set mechanisms to put on the brakes. The private sector has various devices. For example, financial institutions have internal risk management sections. Market discipline is extended by shareholders, creditors and counterparties to guard against excesses by senior management of financial institutions. Meanwhile, central banks and financial regulators and supervisors also function as a braking device. Unfortunately, in these crisis episodes, the devices in both the private and public sectors failed. The failure of these two sets of devices entails very important issues, but in the interest of time, I will focus only on the public-sector device. As a central

³ See Tett [2009].

banker, I believe we need to examine critically and thoroughly the failures of central banks and financial regulators and supervisors.

Conduct of monetary policy

First of all, let me touch upon the conduct of monetary policy. There has already been considerable debate about the relationship between monetary policy and emergence of bubbles. One thing is clear: over-confidence is the core factor which breeds a bubble. In that sense, bubbles do not transpire from expectations of a continuation of low interest rates alone. This is, however, only a half of the truth. The other half is that bubbles do not materialize without expectations that low interest rates will continue. For me, the key question, which applies to many central banks including both the Bank of Japan and the Federal Reserve, is that, why we, as central banks, maintained interest rates at such a low level, in spite of the uneasiness we felt at that time toward the bubble-like symptoms. There are three possible reasons.

First, the economic environment has evolved in a way that imbalances in the economy do not readily show up in the form of changes in the price of goods and services. The success in attaining price stability lent support to public confidence in the central bank's conduct of monetary policy. As a result, inflation expectations of private sector economic entities became well-anchored to a low target inflation rate. Thus, imbalances in the economy began to appear in forms other than inflation of goods and services. Imbalances materialized in different forms such as increases in asset prices and growth of credit extension.

Second, some political, economic and social dynamics influenced central bankers, and it became difficult for them to conduct monetary policy based on factors other than the inflation rate. This mechanism is quite subtle. The logic that price stability is a precondition for economic stability and that the independence of the central bank is necessary for price stability, became gradually but firmly established in the 1990s. At the same time, the granting of independence naturally called for the strengthening of accountability. An easily identifiable benchmark was desired. The framework which best fulfilled such needs was inflation targeting. However, under an inflation targeting regime, the debate tends to center on the relationship between the target inflation rate and

the actual or expected inflation rate. As a result, the cost of justifying adjustments in monetary policy becomes quite high in the eyes of central bankers, when such adjustments are aimed to deal with imbalances which appear in forms other than price indices. Economists focused their attention to the linkage between the output gap and the inflation rate, while awareness toward financial imbalances was limited. Factors which could not be captured through movements in the price of goods and services fell through the cracks. Institutional changes to transfer the responsibility for financial regulation and supervision away from the central bank also accelerated this trend.

Third, the meaning of the danger of slipping into deflation was not necessarily correctly understood in a well balanced manner. In this context, Japan's so-called "lost decade", the experience after the collapse of the bubble, was often cited as an evident example, emphasizing the harmful effects of the continuous decline in the price of goods and services⁴. However, the serious difficulties that Japan faced were overwhelmingly caused by the fall in asset prices rather than the drop in the general rate of inflation. In the Japanese case, real estate prices in major metropolitan areas dropped by 70 to 80 percent from their peaks, while the cumulative fall in CPI was three percentage points between 1997 and 2004. Nonetheless, the Japanese experience was misinterpreted. The prevalent mood at that time can be easily noted in documents such as the IMF's World Economic Outlook released in April 2003⁵ and the transcripts of the 2003 Jackson Hole Economic Symposium hosted by the Federal Reserve Bank of Kansas City⁶. When the Federal Reserve reduced the target for the federal fund rates in June 2003, the aim to avoid "an unwelcome substantial fall in inflation" was provided as the reason for its action. Looking back, during this period, while the risks of deflation were highlighted quite strongly, the subtle role of interest rates to dynamically allocate resources tended to be disregarded. And it was exactly during this period that the seeds of the crisis were sown in the form of the expansion of credit and leverage, and the increase in maturity mismatches.

Financial regulation and supervision

Let me now move on to financial regulation and supervision. Since the mid-2000s, central

⁴ With regard to the appropriateness of the phrase, "lost decade", see Shirakawa [2009].

⁵ See Box 1.1 "Could Deflation become a Global Problem?", IMF [2003].

⁶ Federal Reserve Bank of Kansas City [2003].

banks and supervisors had sent out warning signals on the perceived excesses of various transactions through financial stability reports and speeches. However, beyond such steps, too few remedial actions were taken vis-à-vis individual financial institutions. Of course, it is always quite difficult to take preemptive action on individual financial institutions. But going beyond such general comments, I believe the following reasons can be given for this constraint.

First, confidence in the effectiveness of private sector self-regulation or the disciplinary mechanisms built into financial markets may have been too strong. The continued benign conditions of the macro economy also had an effect. In the “Wealth of Nations”, Adam Smith emphasized the benefits of free competition. However, it seems he was also concerned about leaving market forces alone to dictate all aspects of economic activity. Case in point is the area of finance. He noted that if the rate of interest were to become too high, the greater part of the money would be lent to prodigals and projectors, and money would be kept out of the hands of sober people⁷. Before the current crisis, I had not made much of these words by Smith, but now I have come to feel that I need to assess its implications more carefully.

Second, authorities became more cautious about the discretionary use of their supervisory powers. Regulation is a necessary tool in maintaining financial stability, but it is not possible to design regulation beforehand which can be applicable to all future situations. Therefore, effective supervision becomes important. What becomes necessary is a form of supervision which is adaptable to each financial institution’s unique risk profile. Naturally, such supervision must involve some elements of discretion. However, as the pressure for stringent and prompt accountability increased, supervisors became more cautious about exercising such discretionary powers.

Third, both central banks and supervisory agencies were lacking the perspective of assessing the risks of the financial system as a whole. The traditional philosophy of regulation and supervision was that if the health of individual financial institutions is maintained, the stability of the financial system will also be preserved. However, as the crisis has shown, the interactions among financial institutions as well as between the

⁷ See Smith [1776].

financial system and real economy played a critical role. In that sense, it was crucial to assess and act against the risks to the financial system as a whole. However, such a macro-prudential perspective was not well established.

Revisiting the philosophy behind policy

I have examined the reasons why both monetary policy and regulatory and supervisory policy were not successful in putting on the brakes. Through such considerations, one feels afresh the strong influences of the policy philosophy of policymakers, and furthermore, of the conventional wisdom surrounding policymakers which influence their behavior. As Keynes pointed out, “sooner or later, it is ideas, not vested interests, which are dangerous for good or evil”⁸. It is perhaps time that we revisit the philosophy behind monetary policy and financial regulation and supervision which we have become so accustomed to in recent years. Currently, my views on the direction for reassessment which I find necessary are the following three points.

First, the importance of the objective of central bank policy. Usually, the objective of monetary policy is defined as price stability. In fact, such a definition seemed to be totally reasonable until recently. However, it has now been acknowledged that the role expected of central banks does not match one-to-one with price stability. The experience of the bubble shows that even when prices are stable, the economy can experience huge swings. What is expected of central banks is the attainment of a stable financial environment which provides a basis for sustainable growth. Price stability is certainly one important element of the stability of monetary conditions. However, it is not confined to this. Rather, when a central bank becomes too fixated on short-term price stability, this may complicate the attainment of the ultimate objective of sustainable growth.

Second, the importance of effectively gauging the stability of the financial environment. Central banks need to pay attention to a broad range of financial indicators, encompassing credit, leverage, and maturity mismatches. A “stable financial environment” is an abstract concept and there is no single indicator which can totally capture economic and financial conditions. However, I would say the same is also true for prices. Measuring prices of

⁸ See Keynes [1936].

goods and services enabled by new technology is really daunting task. Price of a search engine is a good example. Even if we seem to have found a single effective indicator, given that it cannot provide a complete picture of continuously changing economic and financial conditions, we must continue to review carefully a wide range of indicators. It is a demanding task, but we must undertake this challenge.

Third, the importance of a healthy amount of discretionary powers. The public sector needs appropriate discretionary powers, both in the area of monetary policy and financial supervision. In spelling out the conditions for exercising the “lender of last resort” function of the central bank, Gerald Corrigan used the words “constructive ambiguity”⁹ when he was President of the Federal Reserve Bank of New York. In recent years, the pendulum had swung substantially toward transparency. However, at the end of the day, the role of central banks, regulators and supervisors is to prevent instability of the economy and financial markets, which could materialize if simply left to the free-market competition. If actions of policy makers were based on mechanical rules which could be fully incorporated into the behavior of market participants, this may rather end up being a source of instability for the market and economy. I believe it is time to bring the pendulum back, at least to some extent, toward allowing more room for discretionary measures.

Concluding remarks

The points I have raised today mean going back to the basics of central banking. But, this does not mean returning to central banks of the past. The *raison d’être* of the central bank to achieve stable financial environment which would enable the achievement of sustainable growth remains unchanged. However, both the economy and financial markets are evolving continuously. After the end of World War II, until relatively recently, a stable financial environment was almost synonymous with price stability. Also, we were quite used to a financial system structure where the health of commercial banks was almost synonymous with financial system stability. However, having experienced the current crisis, we have come to realize that such understandings are now outdated.

When central banks are celebrating success, new problems may be beginning to emerge in

⁹ See Corrigan [1990].

the private sector quietly. By the same token, when central banks are facing difficult challenges, the green shoots to resolve the problem may already be beginning to grow in the private sector. Risks always materialize but in new appearance. In this regard, central banks need to continuously be in a learning mode. As with private-sector economic entities, complacency is the most dangerous risk for central banks. We need to be humble as numerous challenges await the global economy. My colleagues and I at the Bank of Japan will continue to come to grips with these challenges, working in cooperation with fellow central bankers, and financial supervisors and regulators. In finishing my remarks, I would like to request you in the private sector for your continued support and assistance, so that central banks can continue to progress.

Thank you very much for your kind attention.

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